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# What We Say in the NAIC Annual Statement Blank Actuarial Opinion

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## What We Say in the NAIC Annual Statement Blank Actuarial Opinion

Kenneth W. Faig, Jr.\*

### Abstract<sup>†</sup>

The new language adopted for the actuarial opinion in the National Association of Insurance Commissioners' model actuarial opinion and memorandum regulation has been weakened at the same time the responsibilities of the opining actuary have been increased. The restoration of stronger language to the actuarial opinion would enhance the professional image of the actuary. If the legal environment for professional liability inhibits such a change, the opinion should be changed to describe more precisely the work performed and the conclusion reached by the actuary.

Key words and phrases: *model law, valuation, professional liability, good and sufficient provision*

## 1 A History of Life Company Actuarial Opinions

The National Association of Insurance Commissioners (NAIC) model standard valuation law as adopted in December 1990 requires that the annual statement of a life insurance company be accompanied by an

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<sup>†</sup>The opinions expressed in this article are the author's personal opinions do not represent those of his firm or of any other person. The author thanks the anonymous reviewers whose comments helped to improve this article.

actuarial opinion.<sup>1</sup> The wording of the relevant section [3(A)] of the current model law reads as follows:

Every life insurance company doing business in this state shall annually submit the opinion of a qualified actuary as to whether the reserves and related actuarial items held in support of the policies and contracts specified by the commissioner by regulation are computed appropriately, are based on assumptions which satisfy contractual provisions, are consistent with prior reported amounts and comply with applicable laws of this state. The commissioner by regulation shall define the specifics of this opinion and add any other items deemed to be necessary to its scope.

Since 1975 the annual statement instructions adopted by the NAIC have mandated the inclusion of an actuarial opinion in the annual statement filings of life insurance companies. The American Academy of Actuaries (AAA) promulgated Financial Reporting Recommendation 7 governing these statements of opinion. In June 1991 the NAIC adopted a new model actuarial opinion and memorandum regulation that provided new language for the actuarial opinion, with two different texts: one for opinions formed without asset adequacy analysis (Section 7 opinions) and one for opinions formed with asset adequacy analysis (Section 8 opinions). *Asset adequacy analysis* is the term adopted to indicate that the actuary has formulated his or her opinion based upon an analysis of both sides of the balance sheet, using cash flow testing or another acceptable method. The Actuarial Standards Board (ASB) followed with an Actuarial Standard of Practice (no. 22) governing Section 8 opinions and an Actuarial Compliance Guideline (no. 4) governing Section 7 opinions, in April 1993 and October 1993, respectively. Actuarial Standard of Practice no. 14, adopted by the ASB in July 1990, provides guidance to the actuary on when to perform cash flow testing.

## 2 The Old Actuarial Opinion Language<sup>2</sup>

Amidst all the increased work that we must do to form our opinions, I wonder if we actuaries have paid enough attention to the language in

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<sup>1</sup>See the NAIC's *Model Laws, Regulations and Guidelines*, (four volumes, updated to 1996). The model standard valuation law is found in volume 4, pp. 820-821. The model actuarial opinion and memorandum regulation is found at volume 4, pp. 822-824.

<sup>2</sup>The old actuarial opinion language may be found in *Annual Statement Instructions: Life, Accident and Health (L/H 1994)* (updated to July 28, 1994) at pp. 7-9.

which those opinions are expressed. The 1994 NAIC annual statement instructions required that the actuary opine on at least the following items:

- A Aggregate reserve for life policies and contracts (Exhibit 8);
- B Aggregate reserve for accident and health policies (Exhibit 9);
- C Aggregate reserve for deposit funds and other liabilities without life or disability contingencies (Exhibit 10);
- D Net deferred and uncollected premiums;
- E Policy and contract claims—liability end of current year (Exhibit 11, part 1); and
- F “Cost of collection” in excess of loading.

The model language suggested for the actuarial opinion in the 1994 NAIC annual statement instructions was as follows (emphasis added):

In my opinion the amounts carried in the balance sheet on account of the actuarial items identified above:

- A Are computed in accordance with *commonly accepted actuarial standards consistently applied and are fairly stated in accordance with sound actuarial principles*;
- B Are based on actuarial assumptions which are *in accordance with or stronger than* those called for in policy provisions;
- C *Meet the requirements* of the insurance laws of (state of domicile);
- D *Make a good and sufficient provision* for all unmatured obligations of the company guaranteed under the terms of its policies;
- E Are computed on the basis of assumptions consistent with those used in computing the corresponding items in the annual statement of the preceding year-end; and
- F Include provision for all actuarial reserves and related statement items which ought to be established.

In addition, the opining actuary had to indicate that the opinion was formed based on the actuarial standards of practice promulgated by the ASB.

Notice the recurrence of words and phrases with strong, positive connotations in the old opinion language: *accepted actuarial standards*,

*consistently applied, fairly stated, sound actuarial principles, in accordance with or stronger than, meet the requirements, good and sufficient provision.* The old opinion language as contained in the 1994 NAIC annual statement instructions was full of phrases with strong positive connotations. It imparted the impression that the actuary was comfortable with the company's reserve levels based upon the work he or she performed.

### 3 The New Actuarial Opinion Language

The purvey of the new Section 7 opinion found in the NAIC model actuarial opinion and memorandum regulation is essentially the same as that of the old opinion, except that net deferred and uncollected premiums and cost of collection in excess of loading are not explicitly mentioned (see Model Regulation 7(B)(3)). The grid accompanying the scope section for the Section 8 opinion (see Model Regulation 8(B)(2)) includes all these liabilities and, in addition, separate account liabilities, interest maintenance reserve (IMR), and asset valuation reserve (AVR).

The language of the new Section 7 opinion (see Model Regulation 7(B)(6)) is as follows (emphasis added):

In my opinion the amounts carried in the balance sheet on account of the actuarial items identified above:

- A Are computed in accordance with those *presently accepted* actuarial standards which *specifically relate* to the opinion required under this section;
- B Are based on actuarial assumptions which produce reserves *at least as great* as those called for in any contract provision as to reserve basis and method, and are in accordance with other contract provisions;
- C Meet the requirements of the insurance law and regulations of the state of [state of domicile] and are *at least as great* as the *minimum aggregate amounts* required by the state in which this statement is filed;
- D Are computed on the basis of assumptions consistent with those used in computing the corresponding items in the annual statement of the preceding year-end with any exceptions noted below; and
- E Include provision for all actuarial reserves and related statement items which ought to be established.

The statement of conformity with ASB standards of practice is retained.

The Section 8 opinion language (see Model Regulation 8(B)(6)) follows the Section 7 language and then adds (emphasis added):

The reserves and related items, when considered in light of the assets held by the company with respect to such reserves and related actuarial items including, but not limited to, the investment earnings on such assets, and the considerations anticipated to be received and retained under such policies and contracts, make *adequate provision*, according to *presently accepted* actuarial standards of practice, for the anticipated cash flows required by the contractual obligations and related expenses of the company.

The language of the new opinion reflects some significant new obligations imposed upon the actuary. Taking assets and expenses into account is a new element of the Section 8 opinion. The requirement that the actuary specifically reference any changes in assumptions is a new element of both the Section 7 and Section 8 model opinion language. The requirement that the actuary opine regarding the aggregate compliance of the reserves with the minimum valuation standards of the state in which the statement is filed, not the domiciliary state, is also new. An American Academy of Actuaries task force chaired by Shirley Shao of the Prudential has been addressing concerns relating to state variations in valuation laws and regulations and has issued several reports to the NAIC.

## 4 The Language of the Old and of the New Actuarial Opinions Compared

As actuaries we should consider the impression that the new opinion language will leave with the users of life insurance company financial statements and the general public. Table 1 contrasts some of the key phrases found in the old and new forms of the opinion language:

Any practicing valuation actuary knows there are many nuances here. But practicing valuation actuaries are also readers, and virtually any reader would say that the new opinion is couched in language far weaker and far more conditioned than the corresponding language of the old opinion.

What happened? Company insolvencies happened. Lawsuits were filed against major actuarial and accounting firms that did work for

**Table 1**  
**Comparing Opinions**

Old Opinion	New Opinion
Commonly accepted actuarial standards consistently applied;	Presently accepted actuarial standards;
Fairly stated in accordance with sound actuarial principles;	Specifically relate[d] to the opinion required under this section;
Assumptions which are in accordance with or stronger than;	Assumptions which produce reserves at least as great;
Make a good and sufficient provision for all unmatured obligations;	Make adequate provision for the anticipated cash flows.

the insolvent companies. The leadership of the actuarial profession stepped up to the plate with the insurance regulatory authorities and cooperatively developed a package that included both heavier responsibilities for the valuation actuary and more protective language for the actuarial opinion. Society of Actuaries (SOA) past president Walter S. Rugland and AAA general counsel Lauren M. Bloom both worked very hard to assure that the valuation actuary was not exposed to third-party liability lawsuits as a result of the new valuation requirements. (For more on their efforts see Rugland (1992) and Bloom (1993 and 1995).) I do not take issue with the new responsibilities defined for the valuation actuary nor with the desire to protect the valuation actuary from unwarranted third-party lawsuits. I wish to address solely the question of whether the final language of the new actuarial opinion best serves these important goals.

Consider a few instances of the language changes in the actuarial opinion. We used to say we used "commonly accepted actuarial standards consistently applied." Now, we say we use "presently accepted actuarial standards which specifically relate to the opinion required." I question whether this weakening of the language of the actuarial opinion is necessary to protect actuaries from lawsuits. The constitution of the United States protects us from the imposition of *ex post facto* law. Actuaries should be protected against the retroactive imposition of newly adopted actuarial standards of practice and actuarial compliance guidelines by a similar principle.

The old actuarial opinion said that the actuarial assumptions were "in accordance with or stronger than" those required by the policy

forms. The new opinion says that the reserves are “at least as great” as those required by the policy forms. The strong, positive statement of the old opinion language has been made weak and passive. I can envision my fellow actuaries saying: “You’re only talking words—the mathematics is the same!” I submit that the words leave a different flavor with readers.

Now, the real bone of contention. We used to say that the liabilities on which we were opining made “good and sufficient provision for all unmatured obligations”. Now, solely in the Section 8 opinion, we say that the liabilities and the underlying assets “make adequate provision, according to presently accepted actuarial standards of practice, for the anticipated cash flows required by the contractual obligations and related expenses of the company.”

It is unquestioned that the new opinion has greater breadth than the old opinion. The increased responsibility of the valuation actuary responsible for a Section 8 actuarial opinion has already been described. I question, however, whether it was necessary and prudent to go from “good and sufficient provision” to “adequate provision.” Virtually every college or high school student can tell us that “good and sufficient” is higher mark than “adequate.” Most students probably would tell us that “good and sufficient” represents a B grade while “adequate” represents only a C grade. If the language of the actuarial opinion needed to be weakened to this extent, perhaps we should have imitated our academic peers and converted our opinions to a pass/fail basis.

One need only consult an English language dictionary to find all the many positive qualities that the adjective “good” can denote. “Sufficient” is a more mathematical adjective with which we actuaries have greater comfort. The American Heritage Dictionary of the English Language defines “sufficient” as “as much as is needed, enough, adequate.” If “sufficient” is synonymous with “adequate,” why does the phrase “good and sufficient provision” leave so much more favorable an impression than the phrase “adequate provision”?

I do not believe that the colloquial usage of “good and” as an intensifier (e.g., “good and tired”) is involved here. The English language recognizes the mathematical precision of adjectives such as “sufficient,” “adequate,” and “unique” by refusing to compare or intensify them in proper usage. I believe that “good” and “sufficient” have to be analyzed as independent and coequal modifiers of “provision.” Neither is an intensifier or qualifier of the other.

Whence, then, the greater strength of “good and sufficient” as compared with “adequate”? I believe the sources are threefold:



1. The many strong positive denotations and connotations of the word "good";
2. The fact that "sufficient" (e.g., accomplishes the desired goal) has strong connotations while "adequate" (e.g., just barely accomplishes the desired goal; could have been done better) has weak connotations; and
3. The long-standing use of the phrase "good and sufficient provision" has made regulators and other users of the actuarial opinion comfortable with the language.

The third point goes further than the familiar impression left with experienced users of actuarial opinions. In the event of a dispute involving the actuarial opinion, the courts will tend to interpret established language according to established precedents. If you will, "good and sufficient provision" and the other standard opinion language become terms of art through their recognition by experienced users and interpretation by courts of law and by regulators. I believe that most potential users of the actuarial opinion would say that the use of "adequate provision" as opposed to "good and sufficient provision" has weakened the opinion.

## 5 Considering the Best Language for the Actuarial Opinion

I question whether the weakening of the language of the actuarial opinion is necessary to accomplish both the increased responsibility and the prudent protection of the valuation actuary. Consulting actuaries who have been involved in litigation relating to actuarial opinions which they rendered might applaud every possible dilution and conditioning of the language of the opinion. One may question whether the impact on company actuaries has been as large. Most company actuaries don't represent particularly deep pockets as far as the litigator is concerned. The officers and directors of insolvent life companies are often involved in subsequent litigation, but absent smoking gun offenses (e.g., fraudulent diversion of corporate funds), they seem to be well protected by corporate errors and omissions liability insurance coverage. If any of the chairpersons, directors, and officers of the major life companies that have become insolvent over the past two decades have become destitute as a result of the roles they played, their plight has not received coverage in the trade press.

As members of a profession, we actuaries have an obligation to our employers and to the public to perform our work in a professional manner. Public accountability is, after all, the primary element that distinguishes a profession from a trade. Every worker has an obligation to perform his or her work in a workmanlike manner although he or she does not normally issue any opinion or guarantee relating to its soundness; furthermore, his or her legal liability is lessened if he or she performs the work as a common law employee. As professionals, we have an obligation to step aside when our knowledge or our qualifications are inadequate to undertake a potential assignment. We all have to make compromises, and we are all exposed to risk. To some extent we can insure against some of the risks through professional liability insurance coverage if we or our employers can afford to do so.

I question, however, whether fear of financial liability ought to drive the form in which we express our opinions. If the legal environment relating to professional liability is sufficiently adverse, substituting a simple description of the work we perform might be a better alternative than using weak or conditioned language. Consider this proposed Section 8 opinion:

I studied tenth year surplus under the seven interest rate scenarios mandated by the NAIC model actuarial opinion and memorandum regulation. All the scenarios except the immediate 3 percent interest rate increase produced positive tenth year surplus; the immediate 3 percent interest rate increase produced \$2 million negative tenth year surplus. When the company's current \$10 million surplus is interjected into the study, tenth year surplus is positive under all seven interest rate scenarios. I also performed sensitivity testing as required by the model actuarial opinion and memorandum regulation. I performed my work in accordance with the actuarial standards of practice and actuarial compliance guidelines adopted by the Actuarial Standards Board.

The language is direct and tells exactly what the signatory did. I believe that such a factual description of the work performed is potentially more meaningful to users of the actuarial opinion than weak or heavily conditioned language. If the actuary had to establish additional reserves as a result of asset adequacy analysis, the opinion would state this. There are alternatives to weak or highly conditioned language. There is strong language such as "good and sufficient" that the layperson understands. Alternatively, there is an explicit summary of the

results of the actuary's work, similar to the example given in the preceding paragraph. Many actuaries would probably consider the reduction of the actuarial opinion to a mere summary of the work performed an inadequate reflection of the opining actuary's professional responsibility. In addition, a mere summary of the work performed duplicates some of the content of the supporting actuarial memorandum.

There are undoubtedly intermediate positions between the use of the "good and sufficient" language of the old opinion and a mere recapitulation of the work performed. An early exposure draft of Actuarial Standard of Practice no. 22 called upon the actuary to opine that the reserves established had a "substantially better than even chance" of providing for the company's contractual liabilities and associated expenses across the range of scenarios tested. Many actuaries now believe that reserves should allow a 20 percent to 25 percent probability of ruin under stochastic cashflow testing, while reserves + risk-based capital should allow for a 5 percent to 10 percent probability of ruin. Stated another way, reserves should make adequate provision for the company's contractual liabilities and expenses under moderately adverse circumstances, while reserves plus risk-based capital should make adequate provision for the same liabilities and expenses under severely adverse (but not all) circumstances.

While such results are heavily dependent upon the underlying volatility assumptions, probabilities of ruin are a concept which can be expressed meaningfully to the generally public. Perhaps another alternative for the actuarial opinion language is to quantify the probability of ruin which the opining actuary believes to be inherent in the stated reserve basis. While in the last analysis, such an opinion may be just as subjective as opining that the reserves make "adequate" or "good and sufficient" provision for the company's contractual liabilities and expenses, the actuary can actually point to the calculation of the probability of ruin stated in the opinion. The problem remains that if ruin occurs, it will in all likelihood occur under some scenario not explicitly studied by the opining actuary.

As a profession we must decide what form of opinion best serves the interests of our clients, our employers, ourselves, and the public. We should not allow protection against personal financial risk to be the predominant determinant of the language that we decide to use. We have a duty under natural law to support ourselves and our families by gainful work—and most of us would like to increase our wealth and to protect it. As a profession, however, we also have a duty to our employers, to our clients, and to the public to render services in a professional

manner. These duties should come first when we consider the words that we use in our public statements of actuarial opinion.

The words we use in these statements are important. We should not change the words we use without taking into account all the many obligations that they reflect. There is an inherent danger in replacing long-established language with new language, and the danger is intensified if the new language is based on narrow professional interests. The new Section 8 opinion adds many layers of responsibility for the opining actuary. Nevertheless, the weakening and conditioning of the new opinion language gives the reader the impression that the actuary is less confident in expressing his or her opinion than before these new duties were undertaken. In fact, however, the substance and the sophistication of the work underlying the actuarial opinion are greater than ever.

I believe that the words we use in the actuarial opinion should reflect the strength of the professional work we do to form the opinion. It is unlikely that any set of future economic scenarios that we undertake to study in the process of formulating an actuarial opinion will include what actually occurs in the future. If this near-certain failure to predict the future makes it imprudent to express a professional opinion regarding reserve adequacy, I believe that reducing the opinion to a brief description of the work performed is preferable to expressing an opinion couched in weak or conditioned language.

Most good change evolves slowly, with the benefit of the wisdom garnered from experience. The potential restoration of the "good and sufficient provision" language to the actuarial opinion has been mentioned as a bargaining chip for a potential statutory reassertion of the predominant role of the domiciliary state in solvency regulation. In all regulatory processes there is inevitable give and take. With financial instruments as complex as life and health insurance and annuities, each new generation of insurance professionals must reinvent the rules in order to keep pace with change. When the pace of change is accelerating as it is today, we need to be careful when considering changes in long-established language.

## 6 Conclusion

I believe that any proposed revision of the NAIC model actuarial opinion and memorandum regulation ought to consider the language used to express the opinion. A thorough study of the entire issue of professional liability as it relates to the actuary would illuminate the

best direction for any future changes in the NAIC model actuarial opinion and memorandum regulation. To the greatest extent possible, the language that we use to express public statements of actuarial opinion should inspire confidence in the professional work that we have performed in forming the opinion.

The legal environment in which we live and earn our livings must remain an ever-present consideration. Any language that can be twisted to represent us as failed fortune tellers must be avoided. It would be better to describe the professional work performed than to expose ourselves to liability as failed fortune tellers.

I believe that the language we use in public statements of actuarial opinion warrants careful consideration. In the last analysis, it may be as important as the substance of the professional work that we perform.

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<sup>3</sup>Readers should also note that "Actuarial Opinion" is a heading in the subject index of the book *Index to Publications of the Society of Actuaries* published from time to time by the Society of Actuaries. The *Valuation Actuary Symposium Proceedings* published annually by the Society of Actuaries, the *National Association of Insurance Commissioners' Life & Health Actuarial Subscription* (monthly), and the *National Association of Insurance Commissioners' Proceedings* (annual) are also fertile sources of information.